IN THE COURT OF APPEALS OF TENNESSEE
AT NASHVILLE
February 22, 2006 Session

TIME WARNER ENTERTAINMENT, L.P. v. LOREN CHUM.LEY, COMMISSIONER OF REVENUE, STATE OF TENNESSEE

Appeal from the Chancery Court for Davidson County
No. 03-2130-I Claudia Bonnyman, Chancellor

No. M2005-00291-COA-R3-CV

The taxpayers appeal the Chancellor's dismissal under a Tennessee Rule of Civil Procedure 12.02(6) Motion of their refund claim. The claim sought exemption for sales and use taxes paid on alleged industrial machinery and purchases of labor for resale. We affirm the denial of the industrial machinery credit, reverse the denial of sales for resale credit and remand the case for further proceedings.

Tenn. R. App. P. 3 Appeal as of Right; Judgment of the Chancery Court Affirmed in Part, Reversed in Part, Remanded

WILLIAM B. CAIN, J., delivered the opinion of the court, in which WILLIAM C. KOCH, JR., P.J., M.S. and PATRICIA J. COTTRELL, J., joined.

Michael G. Stewart, Ramin M. Olson, Nashville, Tennessee, and Neil I. Pomerantz, Denver, Colorado, for the appellants, Time Warner Entertainment, L.P.

Paul G. Summers, Attorney General and Reporter, and Stephen Nunn, Sr. Counsel, for the appellee, Commissioner of Revenue.

OPINION

Time Warner Entertainment Company, L.P. (TWE) and 13 other plaintiffs filed suit in Davidson County Chancery Court after the Commissioner of Revenue denied their claim for refund of sales and use tax paid from December 1998 through December 1999. The purchases which triggered taxation were of two classes. The taxpayers claimed exemptions first for equipment purchased by TWE and used in "arranging, processing and delivering a cable television programming signal to TWE's customers." They claim that this equipment constitutes "industrial machinery" under Tennessee Code Annotated section 67-6-102(a)(14). In addition, TWE claimed that tangible personal property and labor purchased from third-party vendors in connection with consumer installation and repair services provided to TWE customers qualified as "purchases for

resale" as defined in Tennessee Code Annotated section 67-6-102(a)(28). The taxpayers rely on this Court's decision in *Freedom Broadcasting v. Dept. of Revenue,* 83 S.W.3d 776 (Tenn.Ct.App.2002) as support for the proposition that the cable television signal produced in the provision of cable television services constitutes "tangible personal property," so that the equipment used to create, transmit and receive that signal qualify for the industrial machinery credit. TWE cites Tennessee Code Annotated section 67-6-102(a)(28)(iv) as authority for its claim to the "purchase for resale credit."

The complaint for refund was filed July 25, 2003. The commissioner filed her Tennessee Rule of Civil Procedure 12.02(6) Motion to Dismiss the Complaint on September 26, 2003, originally urging that since the cable television services sold by TWE were specifically defined as an amusement for tax purposes pursuant to Tennessee Code Annotated section 67-6-212(a)(1998), the taxpayers were not entitled to either exemption. The Commissioner argued that TWE's purchases of tangible personal property and services were incidental to the provision of cable services and thus taxable. By way of supplement to the motion, the Commissioner cited the repeal of section 67-6-212-(a)(5) by Chapter 423, section 2 of The Public Acts of 1999 and argued that pursuant to this legislation the provision of cable television service was reclassified as a "taxable privilege," and likewise subsumed the purchases of tangible property and services. The trial court granted the Commissioner's motion and dismissed the claims under Tennessee Rule of Civil Procedure 12.02(6) holding:

> 2. From December 1998 until July 1, 1999, cable television was classified as a service subject to the amusement tax, T.C.A. § 67-6-212(a)(5) (1998 Replacement Volume). From July 1, 1999, through the end of the tax period at issue, cable television was classified as a service taxable as a privilege subject to the sales and use tax pursuant to T.C.A. § 67-6-201(9) (Supp. 1999).
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> 3. Because cable television was classified as a service by these statutes for the tax period at issue, plaintiffs are not eligible to claim the industrial machinery exemption at T.C.A. § 67-6-102(13)(A) (1998 Replacement Volume and Supp. 1999) [now T.C.A. § 67-6-102(16)(A) (Supp. 204)], since their principal business was providing a service and not fabricating or processing tangible personal property for resale. *See AT&T v. Johnson,* 2002 WL 31247083 (Tenn. App. 2002). For the same reason, Plaintiffs cannot claim a tax refund based on resale of labor services, such as installation. Plaintiffs were selling a service, the providing of cable television. Plaintiffs were not reselling anything.
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> 4. This result makes it unnecessary to address Defendant's argument that Plaintiffs did not adequately document that portion of their refund claim based on resale of labor or services.
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> 5. Accordingly, the Commissioner's Motion to Dismiss pursuant to Tenn. R. Civ. P. 12.02(6) for failure to state a claim is granted , and this case is dismissed with prejudice.
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> 6. The Court further finds that the Commissioner is the prevailing party in this case within the meaning of Tenn. Code Ann. § 67-1-1803(d) and is entitled

to an award of reasonable attorneys' fees and expenses of litigation as provided by that statute. The Court finds, however, that determination of the amount of such fees and expenses to which the Commissioner is entitled should await the outcome of any appeals in this case.

I.

The standard of review in tax cases is well settled:

> The construction of statutes and of regulations promulgated pursuant to statutes and the application of those statutes and regulations to undisputed facts are questions of law. *Beare Co. v. Tennessee Dept. of Revenue,* 858 S.W.2d 906, 907 (Tenn.1993). While ambiguities in statutes imposing taxes generally must be resolved in favor of the taxpayer, statutes providing exemptions from taxation are strictly construed against the claim of exemption. *Pan Am World Services, Inc. v. Jackson,* 754 S.W.2d 53, 55 (Tenn.1988) (*quoting Tennessee Farmers' Co-op. v. Jackson*, 736 S.W.2d 87, 90 (Tenn.1987)). *See also Tibbals Flooring Co. v. Huddleston,* 891 S.W.2d 196, 198 (Tenn.1994) ("Every presumption is against the exemption and a well-founded doubt is fatal to the claim.").

Cape Fear Paging Co. v. Huddleston, 937 S.W.2d 787, 788 (Tenn. 1996). When the trial court considers a motion to dismiss under Rule 12.02(6) of the Tennessee Rules of Civil Procedure, the standard is equally well settled.

> A Rule 12.02(6) motion to dismiss for failure to state a claim upon which relief can be granted tests only the sufficiency of the complaint, not the strength of a plaintiff's proof as does, for example, a motion for a directed verdict. *Merriman v. Smith,* 599 S.W.2d 548, 560 (Tenn.Ct.App.1979). The failure to state a claim upon which relief can be granted is determined by an examination of the complaint alone. *Wolcotts Fin. Serv., Inc. v. McReynolds,* 807 S.W.2d 708, 710 (Tenn.Ct.App.1990). The basis for the motion is that the allegations contained in the complaint, considered alone and taken as true, are insufficient to state a claim as a matter of law. *Cornpropst v. Sloan,* 528 S.W.2d 188, 190 (Tenn.1975); *Shelby County v. King,* 620 S.W.2d 493, 494 (Tenn.1981); *Shipley v. Knoxville Journal Corp.,* 670 S.W.2d 222, 223 (Tenn.Ct.App.1984). The motion admits the truth of all relevant and material averments contained in the complaint but asserts that such facts do not constitute a cause of action. *League Cent. Credit Union v. Mottern,* 660 S.W.2d 787, 789 (Tenn.Ct.App.1983). In scrutinizing the complaint in the face of a Rule 12.02(6) motion to dismiss, courts should construe the complaint liberally in favor of the plaintiff, taking all allegations of fact therein as true. *Fuerst v. Methodist Hospital South,* 566 S.W.2d 847, 848-49 (Tenn.1978); *Holloway v. Putnam County,* 534 S.W.2d 292, 296 (Tenn.1976). The motion should be denied unless it appears that the plaintiff can prove no set of facts in support of her claim that would entitle her to relief. *Fuerst,* 566 S.W.2d at 848.

Cook v. Spinnaker's of Rivergate, Inc., 878 S.W.2d 934, 938 (Tenn. 1994). See also *Ragsdale v. City of Memphis*, 70 S.W.3d 56, at 62 (Tenn.Ct.App.2001).

A.

TWE, on behalf of its Memphis cable division, Time Warner Cable of Mid-South (TWC-MS), brought the action along with 13 other companies doing business with TWC-MS. The complaint described the nature of TWC-MS's business as "the sale of cable television programming and related services to subscribers residing in Tennessee," including "the delivery of a cable programming signal to subscribers for which subscribers paid TWC-MS pre-determined fees." As is familiar to all cable service subscribers, the service included "basic" and "premium" channels as well as the option to purchase "Pay-per-view" movies and events for additional fees. In connection with this service, subscribers would rent from TWC-MS, the tangible personal property necessary to access the scrambled signal "(commonly referred to as 'converter boxes')." The rental charge was stated separately on the subscribers' monthly bills. These boxes converted signals received from TWC-MS "head-end" facilities in the state. In addition to these cable services, TWC-MS provided internet access and rented cable modems to some subscribers for that purpose. The complaint includes the following specific averments concerning the nature of the transactions at issue.

> 27. During the Period at Issue, TWC-MS purchased a broad range of machinery and equipment from various vendors which it employed to fabricate, process and deliver programming signals and related services to its customers, as described above. TWC-MS also purchased labor services from various vendors, primarily for the installation of machinery and equipment within its cable network, including at subscribers' premises. The vendors that sold such machinery, equipment, and labor services to TWC-MS during the Period at Issue included Alcatel NA Cable Systems, Inc., CommScope, Inc. of North Carolina, Dobbs Ford, Inc., General Instrument Corporation, Marconi Communications Inc., Motorola, Inc., Scientific-Atlanta Inc., SeaChange International, Inc., 3COM Corporation, Times Fiber Communications, Inc., Trilogy Communications, Inc., TVC, Inc., and Vikimatic Sales Inc., and/or their prospective predecessors-in-interest (individually, "Vendor," collectively, "Vendors").
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> 28. In some instances, Vendors collected sales tax on charges for the machinery, equipment and labor sold to TWC-MS, and subsequently remitted such taxes to the State of Tennessee Department of Revenue ("Department").
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> 29. In other instances, TWC-MS did not pay sales tax on such purchases of machinery, equipment, and labor from Vendors, but instead paid use tax to the Department on the purchased items.
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> 30. In yet other instances, TWC-MS paid sales tax on labor charges imposed by Vendors, despite the fact that TWC-MS intended to resell, and in fact did resell, the labor services to its subscribers. When TWC-MS resold the labor services to subscribers, it collected sales tax on such resales.

> 31. TWC-MS and Vendors timely filed with Department all sales/use tax returns for any and all portions of the Period at Issue during which they conducted business in the State. During the Period at Issue, TWC-MS filed the subject tax returns under the TWE name, and also under one of its d/b/a's, Cablevision of West Tennessee ("Cablevision").

B.

In arguing for the industrial machinery tax credit, the Appellants rely upon the holding in *Freedom Broadcasting* that the broadcast signals in that case were tangible personal property for the purpose of determining the taxpayer's eligibility for the credit. *See Freedom Broadcasting v. Johnson*, 83 S.W.3d, at 783-84. They argue that, like broadcast television services, the provision of cable television service was not exempted from the definition of tangible personal property.

At oral argument on February 22, 2006, Appellants all but conceded that if *AT&T Corp. v. Chumley*, 2005 WL 2739270 (Tenn.Ct.App.2005) survived the pending application to appeal to the Supreme Court, that decision would control their "industrial machinery" credit claim at bar. The Supreme Court denied permission to appeal in that case on April 24, 2006. In that case, this Court determined that the legislature had limited the scope of *Freedom Broadcasting*, in a manner that was fatal to the "industrial machinery" credit sought by AT&T.

> *Freedom Broadcasting* had held that radio and television signals were not "telecommunications" and thus could not be "telecommunications services" but were in fact "tangible personal property" under then existing Tennessee Code Annotated section 67-6-102(29). The result of *Freedom Broadcasting* was apparently not acceptable to the legislature as the ink was barely dry on that decision before legislative intervention occurred by the enactment of Chapter 357 of the Public Acts of 2003. Section 14 of Chapter 357 now codified as part of Tennessee Code Annotated section 67-6-102(34) provides "'tangible personal property' does not include signals broadcast over the airwaves." While this subsequent legislative change does not destroy *Freedom Broadcasting*, it appears to effectively limit its application after the effective date of Chapter 357 of the Public Acts of 2003 (July 1, 2004). The difficulty in relating *Freedom Broadcasting* to the case at bar is that the kind of exclusionary language which removed radio and television signals from the definition of "telecommunications" and thus qualified such signals as "tangible personal property" never existed as to the AT&T central office equipment or signals as were in issue in *AT&T v. Johnson* or as are in issue in the case at bar.

AT&T Corp. v. Chumley, __S.W.3d____, 2005 WL 2739270. The very statutes that define telecommunications likewise define the provision of cable television services. That statutory definition leaves no room for the argument that TWE is engaged in anything other than the provision of a taxable amusement or a taxable privilege, and the decision in *AT&T v. Chumley* controls the

determination. The trial court's dismissal of the claim for the industrial machine credit therefore is affirmed.

III.

As for the second issue raised by TWE, the taxpayer urges that taxes paid on purchases of labor from third party service providers and sold to cable subscribers constituted purchases for resale and were thus exempt from taxation pursuant to Tennessee Code Annotated section 67-6-102(a)(28)(F)(iv) and (vi). The Commissioner argues that, because these repair and installation services were incident to TWE's consumption of tangible personal property in the course of its principal business, i.e. the provision of cable service, the purchases were retail sales and subject to taxation.

As authority for its position, the Commissioner relies on *Nashville Mobilphone Co. v. Woods*, 655 S.W.2d 934 (Tenn. 1983). That opinion concerned the consolidated appeals of a radio common carrier and a related corporation seeking a refund of sales tax paid in connection with the purchase of "radio phone and signaling equipment" which Nashville Mobilphone then leased to its subscribers. The appeal brought by the related company is of particular note in our consideration of the issue at bar:

> A second issue presented for review is raised by a separate taxpayer, Melrose Electronic, Inc. This corporation is not a subsidiary of Nashville Mobilphone Company, Inc., according to the record, but is a related corporation, having common officers and stockholders and sharing common facilities. It is generally in the business of maintenance and repair of radio equipment for various customers, many of which have no relation to Nashville Mobilphone Company, Inc. Insofar as pertinent to the present case, however, Melrose Electronics, Inc., had an arrangement with Nashville Mobilphone Company, Inc., under which it undertook to perform the repair and maintenance work on equipment leased or rented to subscribers and customers of Nashville Mobilphone. If a formal contract between these companies exists, it was not filed as a part of the record. According to the testimony, however, Nashville Mobilphone Company, Inc., in effect, subcontracted or "farmed out" its maintenance obligations to its customers to Melrose Electronics, Inc., for a price somewhat less than Nashville Mobilphone Company, Inc., received from its customers.
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> Nashville Mobilphone Company, Inc., had collected and remitted to the Department of Revenue a sales or use tax on the charges which it made to its customers for repair and maintenance. It is insisted, however, that the transactions between it and Melrose Electronics, Inc., are tax-exempt, again on the theory that this is a sale for resale. In other words it is contended that Melrose Electronics, Inc., actually supplies the services which Nashville Mobilphone Company, Inc., was obligated to furnish to its customers. Each month the latter collects from its customers a fixed fee, a

> portion of which it remits to Melrose Electronics, Inc., whether the latter performs any services or not. In consideration for this arrangement Melrose Electronics, Inc., is obligated to perform any necessary maintenance and repair on the equipment in the hands of the customer whether the actual cost of this does or does not exceed the periodic service charge.
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> The trial judge dismissed the action of Melrose Electronics, Inc., and we affirm. This company is primarily engaged in the business of furnishing repair services, and the furnishing of those services is taxable as a retail sale. T.C.A. § 67-3002(c)(4)(D). The equipment which Melrose Electronics repairs is that of Nashville Mobilphone Company, Inc., which we have already held to be the primary user or consumer of that equipment. It is not furnishing repair services to Nashville Mobilphone Company, Inc. for purposes of resale, and its charges to its affiliated corporation are therefore taxable as contended by the Commissioner.

Nashville Mobilphone Co. v. Woods, 655 S.W.2d 934, 937-8. The record in this case discloses no subscriber agreement of the character described by the court in *Nashville Mobilphone*. The installation and repair services, according to the complaint, were charged separately to the TWE customer as those services were performed.

Of equal import to our decision is the reasoning employed by the Supreme Court in *Cape Fear Paging Services v. Huddleston*, 937 S.W.2d 787 (Tenn.1996). In determining whether paging equipment provided to costumers were retail sales entitling Cape Fear to an exemption from taxation on its purchase of that equipment, the court distinguished the situation from *Nashville Mobilphone* thus:

> In *Nashville Mobilphone,* as in the present case, the taxpayer petitioned for a refund of sales and use taxes paid under protest. The taxpayer provided its customers with two-way radio voice communication and paging services whereby customers with a radio telephone unit could communicate through any conventional telephone in the Bell telephone system. In connection with the service, the taxpayer also leased to its customers various types of radio telephone and signaling devices. At issue was whether the taxpayer's purchases of radio phone and signaling equipment which it leased to its customers were exempt as "sales for resale." The Court found the following statement in a Florida case "persuasive":
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> > "In our resolution of the controversy we are primarily influenced by the simple fact that these hooks, ferrules, wires and gadgets are unused, unusable and of no value in and of themselves to the customer, so as to support payment of a separate consideration for their possession, until such time as appellant makes the proper connections to its system so that the customer can watch cable T.V. For this, and nothing else, the customer pays a consideration in the

> form of his monthly service charge, the only charge made, except for the initial hook-up and equipment deposit."

Id. at 937 (quoting *American Video Corp. v. Lewis,* 389 So.2d 1059, 1061 (Fla.App.1980)). The Court then summarized the evidence in regard to the equipment furnished by the taxpayer in that case.

> We find this reasoning persuasive. As previously stated, appellant does not rent radio phone or signaling equipment to the general public, but only to its subscribers. While a subscriber may furnish its own equipment and still obtain the service, it may not rent appellant's equipment without subscribing to the service. Appellant's equipment in the hands of the customer is completely without value to the customer except in connection with and as part of the service for which the customer subscribes. The ultimate user or consumer of the equipment, therefore, is the appellant, utilizing the equipment as a part of its own "radio common carrier system," and there is no sale for resale within the meaning of the statutes.

Id. at 937 (footnote omitted).

In order to sustain the imposition of the tax in the present case, the rationale of the *Nashville Mobilphone* case would require a finding that the pagers are "unused, unusable and of no value in and of themselves to the customer" and further, the pagers are "completely without value to the customer except in connection with and as part of the service for which the customer subscribes." *See id.* Contrary to the factual finding in *Nashville Mobilphone,* the pagers which are the subject of this case do have value separate and apart from the taxpayer's service. Consequently, purchases of the pagers leased to Cape Fear's customers are exempt from taxation.

Cape Fear Paging Services v. Huddleston, 937 S.W.2d 787, 789-90 (Tenn. 1996). The relevant statutes provide:

> (F) "Retail sale," "sale at retail" and "retail sales price" include the following services:...
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> > (iii) The furnishing, for a consideration, of intrastate, interstate or international telecommunications services;
> >
> > (iv) The performing for a consideration of any repair services with respect to any kind of tangible personal property;...
> >
> > (vi) The installing of tangible personal property which remains tangible personal property after installation where a charge is made for such installation, whether or not such installation is made as an incident to the sale thereof, and whether or not any tangible personal property is transferred in conjunction with such installation service;

Tenn. Code Ann. §67-6-102(a)(28)(F)(iii-iv and vi).

At this point the procedural posture of this case becomes dispositive. In contrast to *Nashville Mobilphone Co., Inc. v. Woods*, 655 S.W.2d 934 (Tenn.1983) and *Cape Fear Paging Co. v. Huddleston*, 937 S.W.2d 787 (Tenn.1996) where both cases had been tried on their respective merits and an appeal had followed, in the case at bar, the appeal is from the trial court's grant of a Tennessee Rule of Civil Procedure 12.02(6) Motion to Dismiss. In *Nashville Mobilphone*, the Supreme Court held that under the facts established, Nashville Mobilphone Company was the primary user or consumer of radio, phone and signaling equipment. In *Cape Fear Paging*, after hearing the proof, the Supreme Court, reversing the Court of Appeals and sustaining the position of the taxpayer, held:

> The proof shows that the taxpayers' customers are the ultimate users or consumers of the pagers leased by the taxpayer to its customers. The taxpayers' purchase of those pagers was for resale within the meaning of the statute.

937 S.W.2d at 790.

In the case at bar we have no factual basis upon which to make the crucial determination and cannot therefore say that Appellant can "prove no set of facts in support of his claim that would entitle him to relief." *Fuerst v. Methodist Hosp. So.*, 566 S.W.2d 847, 848 (Tenn.1978).

The judgment of the trial court disallowing the "industrial machinery" credit is affirmed. The judgment of the trial court sustaining the Tennessee Rule of Civil Procedure 12.02(6) Motion to Dismiss as to the "sale for resale" credit is reversed and the case is remanded to the trial court for further proceedings. Costs of the case are assessed in equal shares to both parties.

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WILLIAM B. CAIN, JUDGE